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Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

January 31, 2007

Subject: Government Auditing Standards: Proposed Revisions to Standards for Quality Control and Assurance and Peer Review

To government officials and others interested in government auditing standards:

GAO invites your comments on the accompanying proposed changes to the quality control and assurance section of the 2003 revision of *Government Auditing Standards*. The proposed changes to the quality control and assurance and peer review section include standards relating to an audit organization's system of quality control and external peer reviews. The finalized version will replace the quality control and assurance section (paragraphs 3.49 through 3.54) of chapter 3 in the 2003 revision of *Government Auditing Standards*.

In response to the wide range of comments we received on the quality control and assurance and peer review section of the exposure draft of *Government Auditing Standards* that we issued for comment in June 2006,¹ we decided to defer any changes to this section of the standards pending further consideration. The remaining sections of *Government Auditing Standards* have been finalized and are being issued² concurrent with our request for comments on this new exposure draft on quality control and peer review. The complete 2007 revision of *Government Auditing Standards* will be available after the quality assurance and peer review section is finalized and incorporated into the standards. Electronic versions of the documents can be accessed on the Web at <http://www.gao.gov/govaud/ybk01.htm>.

The redrafted section on quality control and peer review from chapter 3 includes the following key elements:

- Strengthened emphasis on audit quality and expanded description of the overall objectives and elements of an audit organization's system of quality control, including articulation of six key elements of quality control for achieving high quality throughout all phases of the audit process.
- Added flexibility for audit organizations to have a peer review cycle of up to 5 years for performance audits.
- Increased transparency regarding the effectiveness of audit organizations' quality control systems by requiring that the external peer review reports be made public.

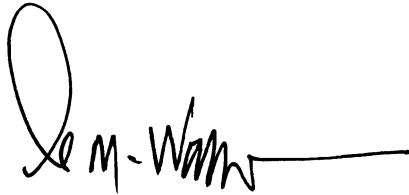
¹ *Government Auditing Standards, 2006 Revision, Exposure Draft* (GAO-06-729G, June 2006).

² *Government Auditing Standards, January 2007 Revision* (GAO-07-162G, January 2007).

Other auditing standards setting organizations are currently working on quality assurance proposals, and we continue to coordinate our efforts and be mindful of any changes they are considering. At the same time, because those proposals are not projected to be completed or effective in the near term, we are proceeding with our quality assurance proposal in order to strengthen the quality control and assurance standards contained in *Government Auditing Standards*. High quality auditing is essential for government accountability to the public and for providing transparency about program results. Effective quality assurance for audit organizations performing government audits is key to the credibility and success of government auditing in fulfilling these key roles. GAO will continue to work with the other auditing standards setting organizations and other audit organizations to further improve quality assurance in government auditing.

We request comments on the draft revisions (see enclosure II) from audit officials and financial management at all levels of government, the public accounting profession, academia, professional organizations, public interest groups, and other interested parties. To assist you in developing your comments, specific questions are included in enclosure I to this letter. When providing comments, please identify the question numbers and/or specific paragraph numbers from the proposed revisions in enclosure II and provide a rationale for your answers. Please send your comments electronically to yellowbook@gao.gov no later than March 30, 2007.

If you need additional information please call Jeanette Franzel, Director, at (202) 512-9471, or Michael Hrapsky, Senior Project Manager, at (202) 512-9535.

A handwritten signature in black ink, appearing to read 'D. M. Walker', followed by a horizontal line.

David M. Walker
Comptroller General
of the United States

Enclosures

Questions for Commenters

The following questions are provided to guide users in commenting on the proposed quality control and assurance and external peer review standards. We encourage you to comment on these issues and any additional issues that you note. When providing comments, please identify the question numbers and/or specific paragraph numbers from the exposure draft, and provide a rationale for your answers.

1. System of quality control – Paragraphs 3.50 through 3.53 provide expanded discussion and elaboration of an audit organization’s system of quality control from the 2003 Revision of *Government Auditing Standards* (GAGAS). Paragraph 3.53 contains the following six elements that audit organizations should address through policies and procedures:

- (1) leadership responsibilities for quality;
- (2) independence, integrity, objectivity, and other legal and ethical requirements;
- (3) initiation, acceptance, and continuance of audit and attest engagements;
- (4) human resources;
- (5) engagement performance, documentation, and reporting; and
- (6) monitoring of quality.

Please comment on the proposed elements that audit organizations should address through policies and procedures as part of a system of quality control.

2. External Peer Review Frequency - Paragraph 3.54 adds flexibility for audit organizations to have a peer review cycle of up to 5 years for performance audits. We believe this will allow more local government audit organizations to comply with GAGAS. It will also allow government audit organizations to have additional flexibility based on their facts and circumstances. The proposed peer review requirement for financial audits is at least once every 3 years, to maintain consistency with the external peer review requirements of other professional organizations.

Please provide your comments on the proposed peer review frequency for performance and financial audits.

3. Transparency of peer review results – The proposed standards call for increased transparency of peer review results in paragraphs 3.61 and 3.62 through the following two mechanisms.

- (1) External audit organizations performing audits under GAGAS would be required to make the peer review reports publicly available (this requirement does not include the letter of comment).

- (2) If the peer review opinion is adverse and the conditions leading to the adverse opinion are related to or impact audits performed under GAGAS, the audit organization also should disclose in each GAGAS report the peer review results until such time as the adverse opinion is replaced by an unqualified or qualified opinion.

Please comment on both of the above proposals regarding transparency of peer review results.

Proposed Revisions to Quality Control and Assurance and Peer Review

Quality Control and Assurance

3.50 Each audit organization performing audits or attestation engagements in accordance with GAGAS must establish an internal quality control system that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements, and that reports issued are appropriate under the circumstances.

System of Quality Control

3.51 An audit organization's system of quality control encompasses the audit organization's leadership, emphasis on performing high quality work, and the policies adopted and procedures established to provide the organization with reasonable assurance that it is complying with GAGAS. The nature, extent, and formality of an audit organization's quality control policies and procedures will vary based on the audit organization's circumstances, such as the audit organization's size and number of offices, geographic dispersion, the knowledge and experience of its personnel, the nature and complexity of the audit work, and cost-benefit considerations.

3.52 Each audit organization must document its quality control policies and procedures and communicate those policies and procedures to its personnel. The audit organization should document compliance with its quality control policies and procedures and maintain such documentation for a period of time sufficient to enable those performing monitoring procedures and peer reviews to evaluate the extent of the audit organization's compliance with the quality control policies and procedures. The form and content of such documentation are a matter of judgment and will vary based on the audit organization's circumstances.

3.53 An audit organization should include policies and procedures in its system of quality control addressing each of the following elements:

a. Leadership responsibilities for quality within the organization: Designation of responsibility for quality of the government audit practice and communication of policies and procedures relating to audit quality. Such actions and communication encourage a culture that recognizes that quality is essential in performing GAGAS audits.

b. Independence, integrity, objectivity, and other legal and ethical requirements: Policies and procedures designed to provide reasonable assurance that the audit organization and its personnel maintain independence, integrity, and objectivity, and comply with relevant ethical principles and applicable legal and ethical requirements.

c. Initiation, acceptance, and continuance of audit and attest engagements: Policies and procedures for the initiation, acceptance, and continuance of audit work, designed to provide reasonable assurance that the audit organization will undertake audit engagements only if it is independent and can comply with professional standards and ethical principles; has the capabilities and resources to do so; and is acting within the legal mandate or authority of the audit organization.

d. Human resources: Policies and procedures designed to provide the audit organization with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles to perform its engagements in accordance with professional standards and legal and regulatory requirements, and to enable the audit organization to issue reports that are appropriate under the circumstances. Such policies and procedures should address the following:

(1) recruitment and hiring of qualified personnel (if applicable),

(2) assignment of personnel with the competence and independence¹ needed for specific engagements, and

(3) performance evaluation and professional development, including continuing professional education.

e. Engagement performance, documentation, and reporting: Policies and procedures designed to provide the audit organization with reasonable assurance that engagements are performed and reports issued in accordance with professional standards and legal and regulatory requirements and that the audit organization issues reports that are appropriate in the circumstances. Examples of such policies and procedures include the following:

(1) information flow and communication provided to engagement teams so that team members sufficiently understand the objectives of their work;

(2) engagement planning and supervision;

(3) compliance with applicable standards;

(4) appropriate documentation of the work performed and the related reviews;

(5) review of the work performed, the significant judgments made, and the resulting audit documentation and report;

(6) procedures for resolving difficult or contentious issues or disagreements among team members, including specialists;

¹ See paragraphs 3.07 through 3.09, and 3.30c of *Government Auditing Standards, January 2007 Revision*, (GAO-07-162G, January 2007) for specific quality control requirements related to personal impairments and performing nonaudit services, respectively.

(7) procedures for obtaining agency comments on draft reports;

(8) policies to require that engagement quality control reviews be performed for all engagements that meet established criteria, and that the review be completed before the report date; and

(9) reporting that is appropriate to the circumstances associated with the engagement, supported by the evidence obtained, and in accordance with applicable professional standards and legal and regulatory requirements.

f. Monitoring of quality: Policies and procedures designed to provide management of the audit organization with reasonable assurance that the policies and procedures related to the system of quality control are suitably designed and operating effectively in practice. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of (1) adherence to professional standards and legal and regulatory requirements, (2) whether the quality control system has been appropriately designed and effectively implemented, and (3) whether the audit organization's quality control policies and procedures have been operating effectively, so that the audit reports issued are appropriate under the circumstances. Monitoring procedures will vary based on the audit organization's facts and circumstances. Regardless of the monitoring methods used, however, monitoring procedures should be sufficiently comprehensive to enable the audit organization to assess compliance with applicable professional standards and quality control policies and procedures for GAGAS audits. Individuals performing monitoring should have sufficient expertise and authority to assume that responsibility. Audit organizations should include the following procedures in their monitoring:

(1) review of selected administrative and personnel records pertaining to the quality control elements;

(2) review of engagement documentation and reports;

- (3) discussions with the firm's personnel (as applicable and appropriate);
- (4) summarization and analysis of the results of the monitoring procedures, with identification of any systemic issues needing improvement, along with recommendations for corrective action. (Under GAGAS, pre-issuance engagement quality reviews are not considered monitoring controls. However, such reviews can be used as part of this summarization and analysis.);
- (5) communication of identified findings to audit organization management; and
- (6) determination of corrective actions necessary, including necessary modifications to the quality control system, and communication of those corrective actions to audit organization personnel.

External Peer Review

3.54 Audit organizations performing audits and attestation engagements in accordance with GAGAS must have an external peer review performed² by reviewers independent of the audit organization being reviewed in accordance with the following timeframes:

- (a) at least once every 3 years for financial audits and attestations, and
- (b) at least once every 5 years for performance audits.³

²The external peer review requirement is effective within 3 years from the date an audit organization begins field work on its first assignment in accordance with GAGAS for both financial audit practices and performance audit practices. Generally, peer reviews are completed within 6 months of the end of the period under review. Extensions of the peer review completion time frames beyond 3 months after the required completion date are granted by the peer review program that has jurisdiction, in consultation with GAO.

³If the financial audit practice is insignificant in comparison to the performance audit practice and there are no other requirements for more frequent peer reviews, the audit organization may use the 5-year peer review cycle for all audits as long as all financial audits performed during the 5-year period are reviewed as part of the peer review.

3.55 Audit organizations may determine, based on their facts and circumstances, that it is appropriate to have a peer review prior to the end of the regular peer review cycle. For instance, in cases when the audit organization has undergone a reorganization or merger, or other major changes have impacted the system of quality control, the previous peer review report may no longer be relevant or applicable. In such cases, it may be appropriate to have a peer review conducted before the end of the regular peer review cycle. This is especially relevant to organizations that use a 5-year peer review cycle.

3.56 The audit organization should obtain an external peer review sufficient in scope to provide a reasonable basis for determining whether, for the period under review,⁴ (1) the reviewed audit organization's internal quality control system was suitably designed in accordance with quality control standards and (2) the reviewed audit organization's quality control policies and procedures were being complied with to provide the audit organization with reasonable assurance of conforming with professional standards.

3.57 The peer review team should include the following elements in the scope of the peer review:

- a.** review of the audit organization's internal quality control policies and procedures;
- b.** review of selected audit and attestation engagement reports and related documentation;
- c.** consideration of the adequacy and results of the organization's monitoring procedures;
- d.** review of other documents necessary for assessing compliance with standards, for example, independence documentation, CPE records, and relevant human resource management files; and

⁴The period under review is at least one year. Peer review programs and audit organizations may choose a longer period to be covered by the peer review.

e. interviews with a selection of the reviewed audit organization's professional staff at various levels to assess their understanding of and compliance with relevant quality control policies and procedures.

3.58 The peer review team should use one of the following approaches to selecting audits and attestation engagements for review: (1) select GAGAS audits and attestation engagements that provide a reasonable cross-section of the GAGAS assignments performed by the reviewed audit organization; (2) select GAGAS audits and attestation engagements with greater emphasis on those GAGAS engagements with higher assessed levels of risk; or (3) select audits and attestation engagements that provide a reasonable cross-section of the reviewed audit organization's work subject to its quality control system, including one or more assignments performed in accordance with GAGAS.⁵

3.59 The peer review team should prepare one or more written reports communicating the results of the external peer review. The report should include the following:

- a.** indication of the scope of the review, including any limitations;
- b.** an opinion on whether the system of quality control of the reviewed audit organization's audit and/or attestation engagement practices was adequately designed based on specified standards or criteria and whether the audit organization's quality control policies and procedures were being complied with during the period reviewed to provide the audit organization with reasonable assurance of conforming to professional standards;
- c.** specification of the professional standards or criteria to which the reviewed audit organization is being held;

⁵The third approach is appropriate for audit organizations that perform only a small number of GAGAS audits in relation to other types of audits. In these cases, one or more GAGAS audits may represent more than what would be selected when looking at a cross-section of the audit organization's work as a whole.

d. for modified opinions, a description of reasons for the modification, along with a detailed description of the findings and recommendations, either in the peer review report or in a separate letter of comments, to enable the reviewed audit organization to take appropriate actions; and

e. reference to the letter of comments, if such a letter is issued.

3.60 The peer review team should meet the following:

a. The review team collectively has current knowledge of GAGAS and of the government environment relative to the work being reviewed.

b. The organization conducting the peer review and individual review team members are independent (as defined in GAGAS) of the audit organization being reviewed, its staff, and the audits and attestation engagements selected for the peer review.

c. The review team collectively has sufficient knowledge of how to perform a peer review. Such knowledge may be obtained from on-the-job training, training courses, or a combination of both. Having personnel on the peer review team with prior experience on a peer review or internal inspection team is desirable.

3.61 An external audit organization should make its most recent peer review report⁶ publicly available; for example, by posting the peer review opinion on an external web site or to a publicly available file designed for public transparency of peer review results. If neither of these options is available to the audit organization, then it should use the same transparency mechanism it uses to make other information public, and also provide the peer review report to others upon request. Internal audit organizations that report internally to management should provide a copy of the external peer review report to those charged with governance. Government audit organizations should also transmit their external peer review reports to appropriate oversight bodies.

⁶This requirement does not include the letter of comment.

3.62 If the peer review opinion is adverse and the conditions leading to the adverse opinion are related to or impact audits performed under GAGAS, the audit organization also should disclose in each GAGAS report the peer review results until such time as the adverse opinion is replaced by an unqualified or qualified opinion.

3.63 Information in external peer review reports and letters of comment may be relevant to decisions on procuring audit or attestation engagement services. Therefore, audit organizations seeking to enter into a contract to perform an assignment in accordance with GAGAS should provide the following to the party contracting for such services:

- a.** the audit organization's most recent peer review report and any letter of comment and
- b.** any subsequent peer review reports and letters of comment received during the period of the contract.

3.64 Auditors who are using another audit organization's work should request a copy of the audit organization's latest peer review report and any letter of comment, and the audit organization should provide these documents when requested.

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